

6/5/98+

**Asian Economics in Perspective**

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*Keynote Address*

*Fourth APEC Roundtable: Regional Cooperation and Asian Recovery*

*Boston, Ma., May 26, 1998*

*forthcoming, Regional Cooperation and Asian Recovery, edited by Peter Petri*

The op-ed pages are ringing with the sounds of giants doing battle -- competing interpretations of recent history, competing models of capitalism -- like Godzilla battling King Kong. There is a lot of blood on the ground, but not everyone agrees whether recent developments show the superiority of free-market capitalism or the reverse. That the Japanese stagnation and East Asian financial crisis has come at the same time as extraordinary US economic performance raises the question whether the American model of capitalism might be superior.

Peter Petri suggested I talk about growth prospects for the region. But I would like to begin by reviewing briefly the origins of the East Asian crisis.

### **Origins of the crisis**

My diagnosis is by now a very familiar one. Macroeconomics played some role in the crisis, though not the lead role. Some mistakes of macro policy were made in 1997 in Thailand. Excessive expansion led to excessive current account deficits and excessive indebtedness.

But large-scale borrowing by itself need not lead to a crisis. Statistical evidence suggests that a large current account deficit or high level of debt are not highly significant predictors of crises. More important than the magnitude of the current account deficit is *how it is financed*, and how the funds are *used*. The composition of the capital inflow matters. East Asian countries had been relying too much on short-term foreign-currency-denominated debt. There was a mis-match between the banks' liabilities (short-term foreign-currency borrowing) and their assets (with much of the money going to speculative real estate deals).

This diagnosis has become conventional wisdom over the last year. But it is also consistent with earlier empirical evidence. In research I undertook with Andy Rose before coming to the Council of Economic Advisers, we found that various aspects of the composition of capital inflows were more significant determinants of currency crashes than were measures of aggregate borrowing like the current account deficit

or budget deficit. High short-term or variable-rate bank debt was found to be a statistically significant positive predictor of the probability of currency crash, while FDI had the opposite effect. Indeed debt-composition variables collectively were the most significant one-year ahead predictors of currency crashes (in a multivariate probit model).<sup>1</sup> Causality cannot be inferred from this exercise, because it was purely statistical.

Nevertheless, it is interesting that the results seem to match what people think happened in 1997 in Asia.

The main problem in East Asia was not macroeconomic, but structural, particularly regarding the financial system. It is always a good idea to hesitate before generalizing across a set of countries as heterogeneous as the Asians. But their financial systems had much in common. Flaws included excessive leverage (debt/equity ratios), and a banking system based excessively on directed lending, connected lending and other collusive personal relationships. Ten years ago, finance experts called it relationship banking, and thought it might help to minimize “problems of asymmetric information and incentive incompatibility;” today we call it “crony capitalism.”<sup>2</sup>

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<sup>1</sup> Frankel and Rose (1996). The three other categories of variables were also significant: external-accounts variables, like the ratio of foreign exchange reserves to imports; macroeconomic variables, like domestic credit creation; and international-environment variables, like foreign interest rates. Each of the four groups was significant at the 99 percent level.

<sup>2</sup> The alternative view (espoused, for example, by Malaysian Prime Minister Mahatir) is that the crisis was inflicted on East Asia by western speculators. US Treasury Secretary Robert Rubin has replied that the flight out of Asian assets into dollars was led by local residents, not foreign speculators. One piece of evidence is that stock prices in Thailand, Malaysia and Indonesia turned downward sooner or more sharply than did the prices of country funds held in New York, even though they represent the identical bundles of securities (Figure 3, from Frankel and Schmukler, 1998). This is consistent with the view that local insiders tend to have better information in emerging markets; they, not foreign speculators, are the first to get out.

The financial system in many Asian countries has had much in common with that in Japan. The Japanese financial system -- once much-vaunted -- is today much-villified. Precisely the attribute of the system that previously appeared to be a virtue, the willingness of banks to go on lending to firms in distress (because the banks had “longer horizons” than impatient American investors), now turns out to have led to serious problems. Borrowers who should have been cut off were not, with the result that further billions were lost.

The Asian style of corporate governance tends in the direction of empire-building. Top managers maximize their firm’s capacity, sales, or market share, rather than what neoclassical economic theory says firms should maximize, namely profitability or the price of the company’s stock. As a result, shareholders, upstart competitors and consumers lose out. For awhile it looked like this was an arcane theoretical point, of interest to economists but not to real-world owners of firms or employees. How could there ever be too much investment or too much growth? Now we see that Asian firms made precisely this mistake. They developed excess capacity in such sectors as steel, shipbuilding, electronics and autos, and are now paying the price. Thus the rules of economics turn out to apply to East Asia as elsewhere.

By comparison, the U.S. financial model is now looking good. This model -- shared with the U.K. and so sometimes called the Anglo-Saxon model (though I prefer Anglo-American, seeing little relevance to who occupied England before the Normans) --emphasizes arms-length market relationships. For example, firms rely heavily on securities markets to finance investment. To be sure, banks play an important role. But even bank loans tend to be made on arms-length terms. The government has little to say about where bank credit is allocated. One lesson now widely drawn from the crisis -- and I believe correctly so -- is that the Anglo-American style financial structure apparently works better after all, as compared to the Japanese-Asian model.

**Dangers of “analysis by hindsight”**

In pronouncing this verdict, one must acknowledge three pitfalls of punditry: the dangers of analysis by hindsight, the dangers of American triumphalism, and the dangers of excessive swings of the pendulum that is known as “conventional wisdom.” The dangers of 20-20 hindsight are clear. Until recently everyone thought that these countries had good fundamentals. Many of us warned of the drawbacks of the financial system. But few thought it would lead to a sharp slowdown, and nobody thought the crisis would be this big.<sup>3</sup>

Financial crises are inherently hard to predict, and one should not after the fact enter into contortions to explain why this one should have been obvious ahead of time. Statistical results produce warning factors that are significant, but typically still do not tell us that the probability of a crisis is greater than 50 percent. Indeed, if there existed indicators that could predict financial crises with high reliability, the market would quickly invalidate the techniques: clever people on Wall Street would adopt them, would sell the assets of any country that was entering the danger zone, and would thereby prevent the crisis situation from developing in the first place.

The dangers of analysis by hindsight are complemented by the dangers of excessive swings of the pendulum and of American triumphalism. The superiority of the American system has in a short span of time become an embarrassingly familiar diagnosis. But just as not everything about East Asian economies was in fact wonderful before 1997, contrary to much that was said then, conversely not everything about them is in fact bad now.

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<sup>3</sup> My own record can be checked: Frankel (1996, 1997). In my view, the only commentator who can be truly proud of what he wrote about Asia beforehand is Krugman (1994). He now denies having predicted that the problems would end in crisis. But in Krugman (1995) he did warn of another boom/bust cycle in emerging markets.

On the negative side, I have already mentioned the structure of the financial system. One should also include on the list of Asian economic flaws: industrial policy and other excessive government interference in the economy. I will even venture to cross over from economics to politics, at the risk of trespassing (whether on the sovereignty of the countries or the turf of political scientists -- I am not sure which is the greater danger). We were told in the past that Asian values did not place as high weight as did Westerners on democracy, free speech and other civil freedoms. I would guess that many Asians believe (now, if not before) that there are *financial* advantages to the rule of law, transparency, freedom of expression, and clearly-established procedures for government succession -- even leaving aside the non-economic benefits of such rights. Kim Dae Jung, for example, has blamed the economic crisis on authoritarianism.<sup>4</sup>

But just as faith in the superiority of East Asia was overdone before 1997, so the disparaging may be overdone now. There was indeed an Asian economic miracle. Thirty years ago it seemed that industrialization was a privilege reserved de facto for the European-settled regions of the world, with the sole exception of Japan. The East Asians disproved this in a few short decades. East Asian success showed that anybody could do it.

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<sup>4</sup> “In every country in Asia, including Korea, the major reason for [economic] failure was lack of democracy.” See Emmerson (1998, p.52).

In the original Industrial Revolution, it took the United Kingdom 58 years to double its income (starting from 1780). It took the United States almost as long (47 years, starting from 1839; and Japan 35 years, from 1885). Korea accomplished the feat in 11 short years, from 1966, and then China in just 10 years (counting from 1977). Among the factors behind the East Asian accomplishment were high saving rates, hard work, and a strong emphasis on basic education and outward orientation (participation in international trade and investment).<sup>5</sup> These are all important determinants of growth that can work in other countries as well. This is important, because it means that Asia can continue to serve, in particular, as an example to other poor countries.

That it has already played this role is worth emphasizing. As developing countries around the world opted for capitalism over state planning in the 1980s, they were not only reacting negatively to the conspicuous failures of the former Soviet bloc, but were also inspired by the positive example of East Asian success. Indeed, the role model role is one of the many reasons why the United States continues to have a major stake in East Asian stability and prosperity, and has led the policy response.

A full acknowledgement of the dangers of analysis by hindsight leaves one with a simple question: if the origins of the crisis lie in the structural flaws in the Asian financial system, then why did it occur when it did? What in economic structure or fundamentals changed between the Asian Miracle and the Asian Crisis?

## **Stages of Development**

Perhaps there exist natural stages of development, and the Asian financial system (with such aspects as

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<sup>5</sup> Frankel, Romer and Cyrus (1996).

relationship-banking) was better suited to countries at early stages of development. After all, financial intermediation by banks is a tremendously important innovation when the alternative for a firm is financing all investments out of family savings or retained earnings from earlier investments. And as long as growth is rapid, high leverage (that is, a high ratio of debt to equity) is sustainable, maybe even desirable. But when growth slows down, the financial system needs to adapt. Firms need to reduce leverage.

Some slowdown in East Asian growth was probably inevitable after the breakneck pace of the preceding three decades. But the slowdown interacted badly with the highly-leveraged financial system. The crisis was the result.

Why do I say that a slowdown was inevitable? On the list of causes of rapid East Asian growth was the simple principle of convergence. (This is in addition to such standard fundamentals as the accumulation of physical and human capital and the outward orientation of the economies.) A country that starts out behind the leaders in per capita income, will tend to close part of the gap over time by growing more rapidly, conditional on those good fundamentals. There are two sorts of reasons for this convergence: the high rate of return on capital in labor-abundant countries, and the opportunity to emulate frontier technology and management practices of the leader countries. But to the extent that the gap has been closed after a few decades, this source of growth is no longer there. Countries run into diminishing return to capital, limits on the benefits of rural-urban migration, and constraints on infrastructure. Also, as they draw closer to the frontier, they no longer have more to learn from those that have gone before than vice versa. Japan had achieved convergence by the 1980s, and Hong Kong and Singapore by the 1990s. Korea and the others still had a ways to go -- a very long ways in some cases. Nevertheless, the basic principle remains, that the smaller the remaining gap, the smaller is the particular source of growth represented by convergence.

There were other reasons as well for the initial slowdown in output growth in East Asia, besides the inevitable convergence. One was the bursting of Japan's pre-1990 asset-market bubble. The Japanese bubble and its collapse were exogenous from the viewpoint of the rest of East Asia, but were in themselves an example of the interaction that I have identified. Financial wealth was accumulated through remarkable

performance in manufacturing and trade; but the wealth outran the limited sophistication of the financial system through which it was surging. I might even go so far as to venture the hypothesis that asset-market bubbles are a rite of passage marking the arrival of a new economic power on the global stage: Holland in the 17th century (Dutch tulip mania), England in the 18th (South Seas bubble), America in the 1920s (stock market and Florida real estate bubbles) and Japan in the late 1980s (stock and land markets).

Another aspect of the initial slowdown in output growth in East Asia was the 1996 slowdown in the world electronics market, which sharply reduced the rate of growth of exports in these countries even before any signs of financial crisis. Whatever its origins, the slowdown that had already begun collided in mid-1997 with the longstanding limitations of the financial system. Convergence was achieved in the same way that a speeding automobile converges with a concrete wall. That is my capsule diagnosis of how Asia got where it is.

### **Prospects for the Future**

Let me now turn to the topic “Prospects for Asian Recovery.” A policy official faces a dilemma. If one is too pessimistic, one risks encouraging the financial markets in their current excessive pendulum-swing away from the merits of the region. But if one is too optimistic, one risks encouraging the U.S. Congress in its complacency.

The situation ranges from better in some countries to worse in others. I am going to say less about the short-term outlook for the region, than on the long-term prospects. It is possible to be upbeat, provided the countries abide by policies along the lines of IMF programs. We can hope that the crisis countries follow a pattern similar to Mexico’s in 1995 (see charts):

- first, a rapid turnaround in the trade balance -- which initially takes the form of import compression, unfortunately (first three months after the December peso crisis);

- second, a gradual recovery in the financial markets: stabilization of the currency, easing of interest rates, and eventually a return of voluntary inflows on private capital markets (three to 10 months)<sup>6</sup>];
- third, a recovery of the real economy: Mexican unemployment peaked at the seventh month, overall economic growth was restored in the fourth quarter (led in part by rising exports, in response to the favorable level of the exchange rate), and the country re-attained its pre-crisis level of real GDP in the eighth quarter.

Larry Krause is about to release his annual forecast for Pacific countries, associated with the Pacific Economic Cooperation Council. It naturally shows recessions this year in Indonesia, Korea and Thailand, but with moderate growth restored in 1999 for all countries.

What about the longer-term? The days of miracle 8 or 10 percent growth rates are probably gone for good. But I am nevertheless optimistic about the longer term, optimistic that Asians will take advantage of the current situation to undertake dramatic needed reforms that they would not have contemplated when times were good. After the debt crisis erupted in Latin America in 1982, many of us feared that if the reduction in living standards there was large and prolonged, it would set back support in these countries for both economic and political liberalization. The reduction in Latin American living standards did turn out to be both very large and very prolonged. By 1989, the word “crisis” seemed no longer applicable to a seven-year affliction, and was replaced by the phrase “lost decade.” Yet the feared retrogression in economic and political liberalization never materialized. To the contrary, virtually every country in Latin America felt it necessary to undertake major economic reforms, including market opening and large-scale privatization never before thought feasible

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<sup>6</sup> Korea has recently been successful at securing longer-term private finance, returning to the private markets in just 4 months. By way of comparison, it took Mexico 7 months in 1995, and 7 years in the 1980s.

politically, and at the same time moved substantially further toward democracy. Eventually, strong growth returned to many of the countries.

I have similar hopes for East Asia. Initially, we feared that the crisis might provoke a backlash in which these countries turned inward, adopting barriers to international trade and investment. So far, this has not happened. Indeed, they signed on to the WTO financial services trade agreement in the midst of the crisis.

Korea is perhaps the clearest example. Korea's political transition -- the first election of an opposition candidate to the presidency -- came virtually the same month as the financial crisis. Initially this appeared an unfortunate coincidence of timing. But there is a benign interpretation: classic democracy in action. Responding to the clear failure of government policies, Korean voters turned to the opposition candidate, and in the process gave him a de facto mandate to undertake difficult changes that his predecessor could not have done.

One would get a distorted impression of Korean political economy if -- unlike the experts attending this conference -- one had first tuned in only when the country landed on the newspaper front pages courtesy of the crisis. One reads that Koreans never dreamed there could be anything wrong with their economy until late last year. Please join me in recalling that the Korea of a couple of years ago was already riven by anxiety over a slowing growth rate, but was frozen in policy paralysis. Economists knew, for example, that labor laws and industrial structure needed to be reformed, as became evident when Korea joined the OECD. The government wanted to rein in the over-diversified empire-building chaebols. But the workers blocked reform of labor laws, even though the chaebol wanted it, and the chaebol blocked reform of the industrial structure, even though everyone else wanted it. The crisis has had the effect, under the leadership of Kim Dae Jung, of breaking the political log-jam, giving firms the freedom to lay off workers, while reining in the excesses of the chaebol in other dimensions (e.g., suppression of union organizing, and unaccountable corporate governance).

A similar story can be told for Thailand, and perhaps other Asian countries as well. Clearly Indonesia is going through a very major transition, and one can hope that it will turn out well, despite recent travails.

“You look at country after country, from Thailand to South Korea, and you find governments that are more accountable to the people, with more rule of law, with less rule by man or connections...If the region can survive the major, major changes and have a peaceful transition period, then the Asia that emerges will be much stronger for the exercise” -- Linda Tsao Yang, U.S. Executive Director to the Asian Development Bank (quoted NYT 5/20/98).

Clearly the adjustments necessary in order for the East Asians to resume their climb up the ladder of economic development are going to be less smooth than our nice neoclassical theories of conditional convergence suggest. One could describe the limits of capital accumulation and rural-urban migration as “diminishing returns.” But the phrase “diminishing returns” connotes continuous differentiability, and does not fully capture the disruptions faced by countries in the advanced stages of development.

The principle generalizes to the financial structure and the political system, as already noted [and perhaps even further to the environment, where the rapidly growing economies again ran into sharp limitations]. Some existing social institutions have to be uprooted when a country has outgrown them, whether to deal with air pollution, or with crony capitalism. Growth will resume. The interplay of economic agents seeking to maximize their individual welfare will continue to be the central mechanism. But the rules and playing field need to be modified a bit, if growth is to be sustained. Perhaps 1997-98 will turn out to have been the turning point when Asians seized the opportunity to make these adjustments.

**Mexico 1994-95 as a Benchmark for Korea 1997-98**



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